Supreme Court of the United States.

OCTOBER TERM, 1920.

No. 663.

DAVID M. GOODRICH,
Plaintiff-in-error,

vs.

WILLIAM H. EDWARDS, United States Collector of Internal Revenue for the Second District of the State of New York.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

PETITION FOR REHEARING IN BEHALF OF PLAINTIFF-IN-ERROR.

Now comes David M. Goodrich, the plaintiff-in-error herein, and respectfully petitions this honorable court for a rehearing of the above entitled cause, for the reasons hereinafter stated.

This cause was argued on March 10th and 11th, 1921, together with the case of *Walsh* v. *Brewster*, No. 742; and the cases of *Merchants' Loan & Trust Company* v.

Smietanka, No. 608, and *Eldorado Coal & Mining Company* v. *Mager*, No. 609, involving similar questions, were argued on January 11th and 12th, 1921. All four cases were decided by this Court on the same day, March 28th, 1921. All of the questions involved were decided in favor of the government, excepting that in the Goodrich and Brewster cases the Court held that where no gain accrued to the taxpayer on the sale in 1916 of an investment acquired before March 1st, 1913, no tax can be imposed on the fictitious profit arising from the receipt on such sale of a sum greater than the market value of the investment on March 1st, 1913. With this exception, the Court held that the Income Tax Act of 1916 intended to tax the increment of capital value when realized in cash by the sale of an investment and that the Act so construed is not unconstitutional.

Similar questions under the Income Tax Act of 1918 arise in the case of *Darlington* v. *Mager*, No. 716, which the Court advanced for argument on April 11th, 1921, prior to the decision of the above mentioned cases.

It is respectfully submitted that in its decision of these cases the Court has overlooked certain considerations which have an important and perhaps controlling bearing on the questions involved and that for these reasons a rehearing of this cause is desirable in the interest of the millions of taxpayers and thus of the Government itself.

We respectfully refer to the brief and reply brief heretofore submitted on behalf of the plaintiff-in-error, and to the brief of Hon. T. P. Gore and Hon. Hoke Smith, filed as *amici curiae*, for a more full statement of the questions involved in this petition; and also to the considerations presented in petitions for rehearing submitted in Nos. 608, 609 and 742, which, in order to avoid repetition, we beg leave to incorporate and adopt in this petition.

In addition to the aforesaid considerations, we briefly state the following grounds for this petition and the relief sought thereby:

1. In its opinions in these cases, the Court, after quoting section 2 (a) of the act of September 8, 1916, has assumed without further consideration that the act includes the increment of value derived from the sale of an investment as a taxable item.

We respectfully refer the Court to Point III and the appendix of the brief heretofore filed in behalf of the plaintiff-in-error, and also to his reply brief, to the effect that the Income Tax Law of 1916, analyzed and construed in the light of circumstances existing when it was enacted and the understanding of Congress, was not intended to tax profits received on the sale of an investment. The Solicitor General has conceded that the Act of 1913 was not so intended (as appears from his brief, page 28, in the *Merchants' Loan & Trust Co.* case, No. 608, and from his brief, page 6, in the *Goodrich* case, No. 663), and it is submitted that *Lynch* v. *Turrish*, 247 U. S. 221, so determined, for under the doctrine laid down in *Lynch* v. *Hornby*, 247 U. S. 339, the increment under consideration in the *Turrish* case was taxable even though it accrued prior to March 1st, 1913. It is respectfully submitted that the Court in this respect in its opinions in the present cases overlooked this consideration. And if this increment was not taxable under the 1913 Act it was not taxable under the 1916 Act, as is recognized from the opinion of the Court in the *Merchants' Loan & Trust Co. case* (No. 608) in which the Court stated:

> "There can be no doubt that the word (income) must be given the same meaning and content in the Income Tax Acts of 1916 and 1917 that it had in the Act of 1913."

This question of the proper construction of the 1916 Act was, owing to lack of time, not fully argued in the present case, and it is respectfullly submitted that, in so vital a matter, an opportunity for a reargument would be beneficial and advisable from every point of view.

2. On the question of the construction of the Sixteenth Amendment to the Constitution of the United States, the Court has adopted as its definition of the word "incomes" the definition previously formulated in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, 415 (decided in 1913), and in *Eisner* v. *Macomber*, 252 U. S. 189, 207 (decided in 1920). Yet in the former case the Court was defining the word "income" in the Corporation Excise Tax Act of August 5, 1909, under which, as heretofore pointed out in the plaintiff-in-error's brief, totally different considerations were involved; and in the latter case the definition was not essential to the determination of the case, was not, therefore, fully considered in the submission of the case, and resulted from a concession by counsel of a point not involved in the case.

We submit that the true definition of the word "incomes" in the Sixteenth Amendment is that expressed in the opinions of the Courts rendered before the adoption of the amendment and understood by Congress when framing it and by the States when accepting it—notably *Gray* v. *Darlington*, 15 Wall. 63 (1872), the English decisions and the opinions of the State courts defining the respective rights of life tenants and remaindermen under trusts—rather than that evolved in opinions rendered after the adoption of the amendment; and that the earlier meaning became embodied in and an unseverable part of the Sixteenth Amendment.

3. It appears from the opinion of the Court in the *Merchants' Loan & Trust Co.* case (No. 608), adopted in the other three cases, that counsel in the briefs and oral

arguments in the four cases decided on March 28th must have created a misapprehension in the mind of the Court with respect to the distinction they sought to make between profits accruing to a trader in the course of his business and those resulting from the sale of an investment, for the Court (p. 6) refers to the argument "that the word 'income' as used in the Sixteenth Amendment and in the Income Tax Act we are considering does not include the gain from capital realized by a single isolated sale of property but that only the profits realized from sales by one engaged in buying and selling as a business —a merchant, a real estate agent, or broker—constitute income which may be taxed," and further says "that there is no essential difference in the nature of the transaction or in the relation of the profit to the capital involved, whether the sale or conversion be a single, isolated transaction or one of many."

The distinction which counsel sought to make was not based in any particular on this ground, and the phrase "isolated transaction" was adopted from the ruling of the Treasury Department (T. D. 2090, Dec. 14, 1914) merely as a convenient phrase to differentiate the occasional sale of an investor from the constant buying and selling of a trader who depends on his transactions for his livelihood.

Whether the transactions involved are one or many makes no difference, excepting in so far as constant sales might be held to convert an investor into the class of traders. But the distinction between sales by a trader and by an investor has been recognized for almost a century under the British Income Tax Acts, and in many other respects, including all of the Income Tax laws of this country. It is an inherent difference so ingrained in the mind through many years that it must be considered as having been before the framers of the Sixteenth Amendment and of the Income Tax Acts.

In the briefs heretofore submitted in the four cases determined on March 28th and in the petitions for reargument to be submitted in the other three cases, this distinction has been pointed out, and we adopt the considerations therein expressed. We also beg to call the attention of the Court to this further consideration which may throw some light on what we believe to be a fundamental difference.

Realized increment of value such as is involved in this case is not the basis for the taxation of income in the hands of a merchant or trader any more than it is in the hands of an investor; and the contention that there is no essential or fundamental difference between the two cases and that increase in value realized by an investor is income because increase in value realized by a trader is income is inapplicable.

The business profits of a merchant have only the remotest sort of relationship to realized increase in value. Whether the merchant makes a profit in any one transaction or in a series of transactions does not depend on increase in value in the property in which he trades, but on his ability to obtain a higher price for the goods on selling than he paid for them on buying. The profit is the result of the successful conduct of the business—buying in one market and selling in another, buying at wholesale and selling at retail, buying raw material and selling the finished product, underwriting an issue of bonds and selling them in small lots at an advance. In all of these cases increment of value, if it enters in at all, is a negligible element in the business profit and the profit may accrue where values as represented in their cash equivalent have fallen.

Under the Income Tax Acts a merchant or trader is not taxed, at least directly, on any realized increase in value of one article or of a thousand articles. In his return he is required first to state the amount of his *total*

sales and income from business or professional services. From this he deducts the cost of goods sold (including labor, material and supplies, merchandise bought for sale, other costs, plus an inventory at the beginning of the year and less an inventory at the end of the year; salaries and wages; rent on the business property; interest on business indebtedness to others; taxes on business and business property, repairs, wear and tear, obsolescence, depletion, and property losses; amortization of war facilities; bad debts arising from sales or professional services; and other expenses. The net income from his business or profession is then carried into the income on which he is taxed.

This net income has only the remotest relationship to any realized increase in value of any of the commodities bought and sold by the merchant. Of course in certain transactions there may have been an increase in value which was eventually reflected in the net income, but any increase of value realized by a trader on any one or more transactions is not and never has been the basis for ascertaining the income upon which he is taxed. That basis is the *total receipts* from his sales, less his cost of goods and business expenses.

If there is "no essential difference in the nature of the transaction or in the relation of the profit to the capital involved" with respect to increase in value realized by an investor from that realized by a trader, then the increase in value realized by an investor is not taxable income because it is not, as such, taxable income when realized by a trader. The decision of the Court in the cases now under consideration, holding that an increase in value realized by an investor is taxable income, thus discriminates against the investor and imposes a tax on him on his total realized increase in value where no such tax is imposed on the trader or merchant.

The distinction between the net annual profits of a merchant or trader and the increase in value of an investment realized by an investor is fundamental and has, it is submitted, always been recognized by the courts until the present decisions; it has always been held that the former is income and that the latter is merely an increase in principal. This doctrine was recognized in *Gray* v. *Darlington*, 15 Wall. 63, approved in *Lynch* v. *Turrish*, 247 U. S. 221; the English cases have always made the distinction; and in all jurisdictions where the respective rights of life tenant and remaindermen under trusts have been under consideration the realized increase in value of an investment has always been held to be principal. Where a trustee has invested in 100 shares of stock for $10,000. and in ten years sells them for $100,000, no court would hold that the difference of $90,000. can be distributed among the life tenants. It is increase of the capital for reinvestment for the ultimate remainderman. On the other hand, where a banking business has been bequeathed to a trustee, who has been directed to continue it and who in the first year, through the buying and selling of stocks and bonds makes a profit of $90,000., no court holds that that is part of the capital which passes to the remainderman; it is clearly income which must be distributed among the life tenants. (*Thorn* v. *De Breteuil*, 179 N. Y. 64) This clearly illustrates the absolute, essential and fundamental distinction between profits realized by an individual on the sale of an investment and the profits made in any business, the result of the difference between the gross receipts and the losses and expenses and other charges of the business.

A further fundamental difference between traders and investors, apparently overlooked by the Court and not referred to in arguments, oral or written, heretofore submitted, is that with respect to the trader a mere appreciation or increment of value in the property in

which he trades, not realized by sale, is an item of his taxable income and therefore taxed, under the system of inventories approved and enforced for many years, while in the case of an investor it is settled by the present decisions as well as by all the recent decisions in point, that unrealized increment of value in capital investments is neither taxed nor taxable.

The present decision holding that increase of value realized by an investor is income discriminates against the investor, since on the same state of facts the merchant or trader is not taxed. The distinction between the net annual profits of a trader and the realized increase of value of an investor was not apparently made clear to the Court, and the opportunity for a full reargument of the question is earnestly desired.

4. The effect of the present decisions of this Court, as expressed in its opinion in the *Merchants' Loan & Trust Co.* case, upon the respective rights of life tenants and remaindermen in trusts will certainly be confusing and may be startling. If a profit like that involved in such case is income for the purpose of taxation, why is it not likewise income to be paid over to the life beneficiary? Undoubtedly the present decision will be quoted to that effect, and if followed will overturn the settled law of all jurisdictions.

It is respectfully submitted that the statement of the Court, that "the opinions of the courts in dealing with the rights of life tenants and remaindermen in gains derived from invested capital, especially in dividends paid by corporations, are of little value in determining such a question as we have here, influenced as such decisions are by the terms of the instruments creating the trusts involved and by the various rules adopted in the various jurisdictions for attaining results thought to be equitable" (p. 7), scarcely meets the argument based on such decisions. In the simple case where property

is left in trust to pay the income to A for life and on his death the principal to B, without further direction, it has always been held that a profit accruing through the sale of an investment is principal and must be reinvested. Is this principle of law overruled by the present decisions of this Court? Certainly those decisions will tend to unsettle the rule, if not to overrule it; and if the $700,000 profit considered in the *Merchants' Loan & Trust Co.* case is taxable income the trustee might well be compelled by the life tenant (apart from the specific provisions of that trust instrument) to pay it over to her.

The doubt created by the present decisions should, we submit, be resolved on a reargument of this cause.

5. In its opinion in the *Merchants' Loan & Trust Co.* case, the Court has briefly dismissed the British income tax decisions as "interpretations of statutes so wholly different in their wording from the acts of Congress which we are considering that they are quite without value in arriving at the construction of the laws here involved."

Yet since 1799, except for the period from 1816 to 1842, England has had income taxes,* and at least since 1842 these taxes have been imposed on "the annual Profits or Gains arising or accruing to any person" (see 5 & 6 Vict. c. 35, 1842, p. 238; 16, 17 Vict. c. 3452, 1853). The words "annual profits or gains" in our Income Tax Laws were doubtless taken from these British Acts, and the uniform line of authorities (quoted in the plaintiff-in-error's main brief at pages 30 to 35) in England and in the British Colonies, holding that these words do not include the profit or increment of value when realized in cash on the sale of an investment, are surely pertinent in the construction of an Act of Congress adopted with

* Encyclopaedia of the Laws of England, 2nd ed., Vol. VII, p. 60.

this settled definition before it and, as shown by the debates, fully known to Congress. It is surely no presumption to say that both the Sixteenth Amendment and the Income Tax Acts were framed in the light of the British precedents, and as stated by this Court, "that Congress, in adopting the language of the English act, had in mind the constructions given to these words by the English courts, and intended to incorporate them into the statute" (*Interstate Commerce Com.* v. *B. & O. R. R.*, 145 U. S. 263, 284; see also *Interstate Commerce Com.* v. *Del., L. & W. R. R.*, 220 U. S. 235, 253-4; *McDonald* v. *Hovey*, 110 U. S. 619, 628).

Thus, we submit, the British decisions were entirely pertinent in the construction of the Sixteenth Amendment and of the Income Tax Acts, and if, through failure to make this clear to the Court, those decisions were not given full consideration and the weight to which they are entitled, we respectfully ask for the opportunity to reargue this point.

6. The effect of the present decisions is, we believe, to overrule *Gray* v. *Darlington*, 15 Wall. 63, and *Lynch* v. *Turrish*, 247 U. S. 221.

It does not seem to us that the former case can be limited to the terminology of the 1867 Act. The Court in its opinion certainly makes no such limitation. If it had intended to tax the income of the year in which the gain accrued and was received, it could have directed an apportionment of the profits, but no such opinion was expressed. The Court clearly laid down the general doctrine that such profits on the sale of an investment are not income at all, but an increase of capital, saying (at p. 66):

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in

> value in no sense constitutes the gains, profits or income specified by the statute. It constitutes and can be treated merely as increase of capital."

And in *Lynch* v. *Turrish* this Court said of the *Darlington* case (at p. 230):

> "This case has not been since questioned or modified."

And further:

> "Indeed, the case decides that such advance in value, is not income at all, but merely increase of capital and not subject to a tax as income."

And while the advance in value in the *Turrish* case accrued prior to March 1st, 1913, the decision of the Court, we submit, was not based on that consideration and in view of the decision made on the same day in *Lynch* v. *Hornby*, to the effect that dividends declared after that date were taxable income even though earned prior thereto, could not consistently have been so based.

Does the Court intend to overrule *Gray* v. *Darlington* and *Lynch* v. *Turrish* in favor of the definition adopted in two cases where the question was quite different or not involved at all?

The opinion of the Court in the *Merchants' Loan & Trust Co.* case dismisses *Gray* v. *Darlington* and *Lynch* v. *Turrish* with only a brief reference, but the effect of the decision is, we submit, to overrule those cases. Yet the doctrine of *Gray* v. *Darlington* has been regarded as the settled law of the land for nearly half a century and was fully appreciated and understood by Congress when the Sixteenth Amendment was adopted, as well as when the Acts of 1913 and of 1916 were under consideration (Appendix to plain..iff-in-error's brief, p. 83). What the

meaning of the word "incomes" in that Amendment is must surely be gauged by the construction given to it by this Court and by common usage prior to and at the time of the adoption of the amendment rather than by any definition evolved in cases decided after the Amendment to the Constitution had been declared in effect.

In *Gray* v. *Darlington* this Court solemnly declared that realized advance in value does not constitute gain, profits or income, but does constitute merely increase of capital. That meaning of the word "income" was the recognized meaning of the word when the Sixteenth Amendment was adopted. Therefore, when the word "incomes" was used in the Amendment it had that meaning and could have no other meaning, and no subsequent definition of the word can affect the situation.

We earnestly ask the opportunity to reargue this question.

For these reasons, and for the additional reasons stated in the petitions for rehearing submitted in numbers 608, 609 and 742, and in the brief and oral argument in the case of *Darlington* v. *Mager*, No. 716, the plaintiff-in-error respectfully petitions this Court that an order may be made for a rehearing in this cause on a day to be appointed by this court and upon such points as the Court may direct.

The undersigned members of the bar of this Honorable Court and of counsel for the petitioner certify that, in their opinion, it is eminently proper that this writ of error should be reheard and reconsidered by this Court and that this petition is well founded in point of law and is presented in good faith and in the conviction that the

questions involved in this cause, of such moment to the citizens of this country, should be presented to this Court fully and completely on a rehearing of this cause.

DAVID M. GOODRICH,
Plaintiff-in-Error,
by LANGDON P. MARVIN,
HENRY M. WARD,
of Counsel.